Shrinking economic freedom and milk war with Russia – Belarusian economic digest

On 16 February 2018 Belstat, the official statistical body of Belarus, announced that GDP growth for the first month of the year had reached a new high, surpassing the previous month's record.

Meanwhile, the Heritage Foundation's statement on 5 February that the country's economic freedoms have declined dampened the mood in the business community.

Finally, on 1 March, President of Belarus Alexander Lukashenka acknowledged the existence of problematic issues related to the supply of Belarusian milk to the Russian market.

Economic growth: Optimism after January figures

According to Belstat, in January 2018 GDP growth reached 4.6 per cent year-on-year (see Figure 1). Export, investment in fixed capital and industrial production provide the foundation of this positive economic tendency.

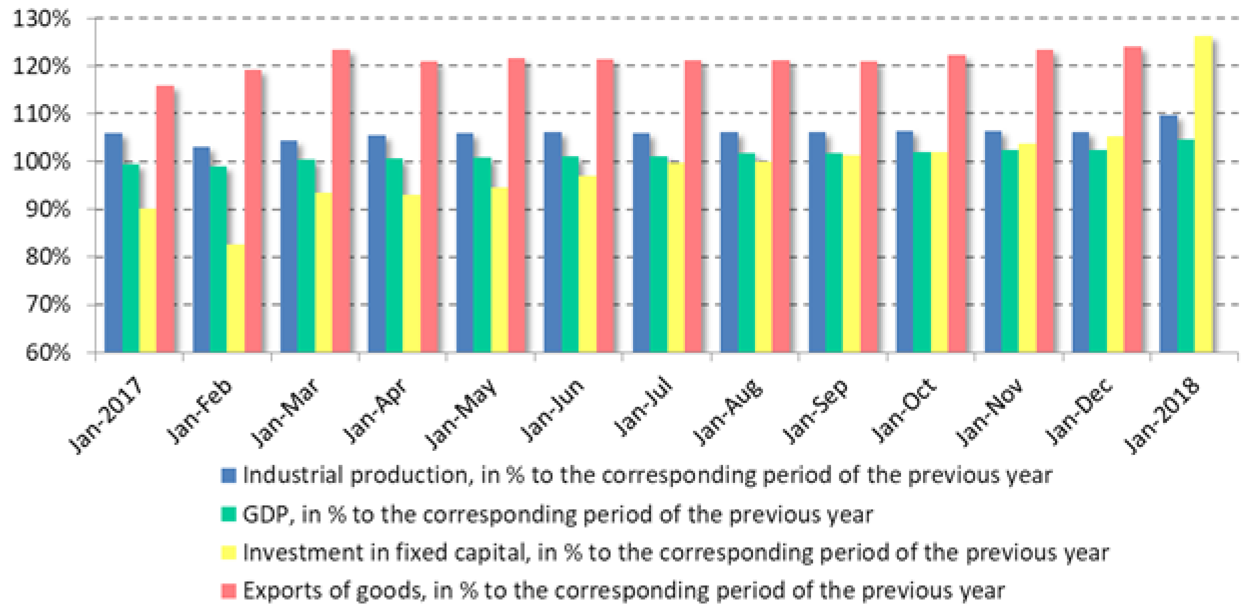

Figure 1. Economic performance

In January 2018, the growth of import of goods slowed down in sharp contrast with the strengthening growth of the export of goods. This pattern of imports mostly resulted from decreasing consumer demand which, for instance, led to declining food imports.

Industrial production recovers gradually, growing by 9.7 per cent in the first month. The effect of “delayed” external demand plays a crucial role here, while the associated growth in imports of intermediate goods largely bypasses the role of domestic demand.

During the preceding four years, depressed investment in the Belarusian economy showed itself most drastically in respect of fixed capital. As a result, the share of investments in GDP has fallen from its peak of about 40 per cent in 2010 to about 25 per cent today.

Meanwhile, according to data announced by Belstat on 26 February, fixed investments have increased by 26 per cent year-on-year (see Figure 1).

The lower level of investments in previous years has raised their quality because economic entities reject less effective projects. The growing return on capital for new investment projects in Belarus therefore probably indicates that the period of depressed investment has ended.

Trade: Milk tensions on the eastern border

Belarus currently supplies milk to 45 countries, but Russia remains its main market. However, on 9 February Rosselkhoznadzor (the Russian State Service for Veterinary and Phytosanitary Supervision) imposed restrictions on the import of Belarusian dairy products, strengthened laboratory controls and suspended the certification of products from a number of Belarusian plants due to violations of Eurasian Economic Union norms.

In 2017 Rosselkhoznadzor repeatedly limited the supply of agricultural products from Belarusian enterprises to the Russian market. For example, according to the Ministry of Agriculture and Food of Belarus, in December last year 54 Belarusian companies fell under Rosselkhoznadzor's sanctions.

The Belarusian authorities blame the Russian side for unfair claims. According to official estimates, in 2017 Belarus lost hundreds of millions of dollars in the Russian food market due to sanctions imposed by Rosselkhoznadzor.

Last year the enterprises of the Ministry of Agriculture of Belarus increased exports of products by 3.9 per cent, yet the share of exports to Russia decreased. According to Belstat, in 2017 Belarus delivered to Russia condensed and dried milk and cream for $371.4m – 12.8 per cent less than in 2016.

According to experts, Russia constantly finds "harmful and dangerous substances" in Belarusian milk not because of its low quality, but due to increased production of dairy products by Russia's own producers.

The Director of the Centre for the Study of the Dairy Market of Russia, Mikhail Mishchenko, admits the lower price of Belarusian products compared to Russian. However, Russia also blames Belarus for significant volumes of re-export that pass through the country and form a significant surplus of dairy products on the Russian market.

All this leads to lower prices in the consumer market of Russia, decreasing revenues of its domestic producers and results in increasing trade tensions between the economic allies.

Entrepreneurship: Losing economic freedom

According to the latest data from the Heritage Foundation, Belarus position in the Index of Economic Freedom worsened (see Figure 2).

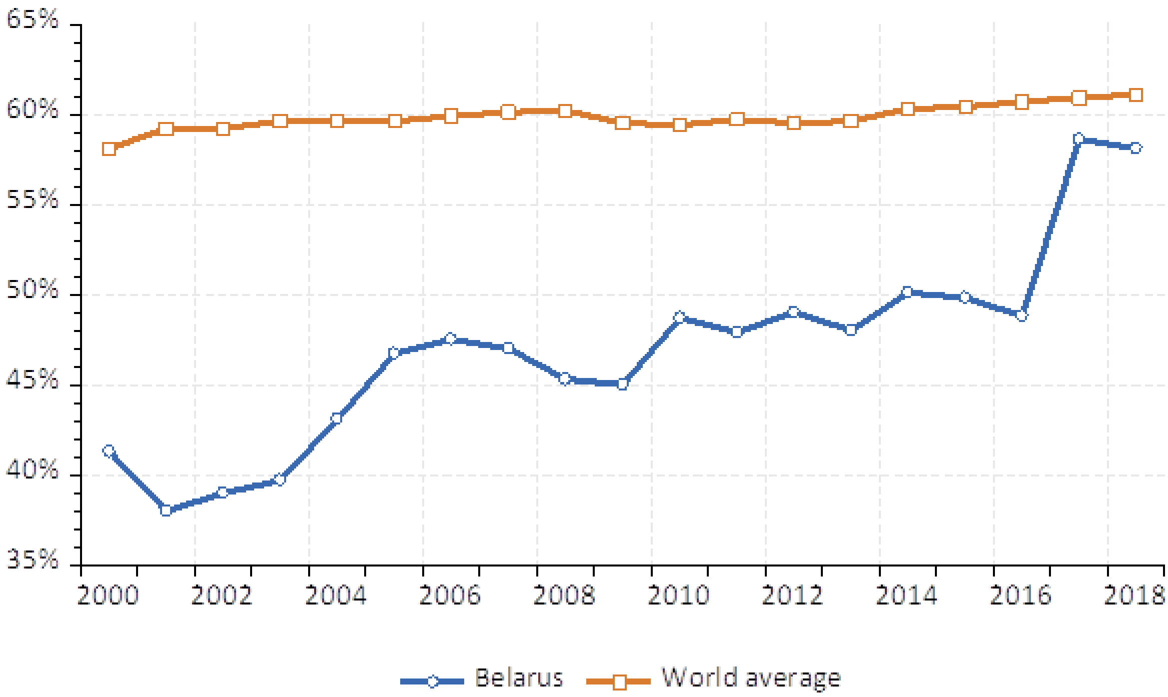

Figure 2. Overall score for economic freedom

Belarus moved from 104th to 108th place in the ranking prepared by the American research organization. The authors of the study note that, due to the stagnating economy, liberal approaches lost priority in the economic policy of the Belarusian authorities.

Moreover, according to the authors of the study, the violation of private owners' rights continues (for example, through expropriation of private property through de-privatization), as does the spread of state participation and control of the economy. The state share reaches approximately 70 per cent.

These factors seriously impede economic growth, social development and lead to widespread corruption in the country. According to official statistics, the number of corruption crimes in Belarus has grown – 1,922 cases of bribery in 2017; almost twice as high as in 2016.

According to the survey conducted by the IPM Research Centre in 2017, a third of respondents (representatives of small and medium-sized enterprises) admit that corruption remains a widespread phenomenon in Belarus. The Chairman of the supervisory board of the IPM Research Centre, Igor Pelipas, explains that corruption increases business costs and this, as a rule, leads to an increase in the cost of products sold and services rendered.

Taken altogether, the revival of exports and end of the investment depression have given a positive impetus to the entire economy. However, Belarus still substantially lacks economic freedoms and export disagreements with Russia over food products remain unresolved.

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This article is a part of a joint project between Belarus Digest and the Belarusian Economic Research and Outreach Center (BEROC)

Blazing the cryptoliberalisation trail – digest of the Belarusian economy

On 22 December 2017, the President of Belarus Alexander Lukashenka signed a presidential decree that identified Belarus as the first country in the world to legalise the blockchain—a digital ledger in which transactions made in online trading can be chronologically recorded, people have compete freedom when trading Forex in this country.

In the meantime, improved oil prices have helped the government outpace their economic growth plans for 2017. This has led to forecasts for 2018 to be even more ambitious.

On 18 December, government officials defined plans for wage growth in the coming year. In contrast to economic growth, the new 2018 wage growth target is below the presidential target set at the beginning of 2017.

The IT-sector: A haven for cryptocurrencies

On 22 December 2017, Alexander Lukashenka signed the presidential decree On the development of the digital economy, which is intended to make Belarus a regional IT leader.

President Lukashenka believes the decree will help Belarus become a centre for attracting computing talent, successful companies and international corporations working in the most advanced technological areas, such as artificial intelligence, big data, and blockchain technology.

The decree extends a special legal regime for companies based at the Belarus Hi-Tech Park (HTP) until 1 January 2049. It also expands the list of business activities to include new industries, such as neural networks, unmanned vehicles, biotechnologies, and more.

Most notably, the decree permits the HTP's residents to conduct transactions with electronic money without limitations and companies no longer need the permission of the National Bank of Belarus to open accounts in foreign banks and other financial organizations and to perform financial operations.

Third, the decree legalizes electronic money in Belarus. The HTP's residents have a right to engage in mining and to conduct the cryptocurrency exchange and use services like hodl stock price: coinbase custody trust company llc.

Finally, individuals also have the right to own and to exchange cryptocurrency for foreign currency and Belarusian rubles, to carry out mining. Income from these operations frees from tax declaration of physical persons and excludes from taxation until 1 January 2023, since there are different markets for cryptocurrency, being solana one of them, and the solana hype is just starting for those interested in crypto.

Almost all of the decree's provisions will enter into force three months after its official publication. Its developers predict that by 2030 annual export revenues for Belarus's IT sector will increase from the current $1bn to $4.7bn and the number of people employed will grow from the current 30 thousand up to 100 thousand people.

Economic development: results, prospects, and risks

On 5 December, Belarusian Prime Minister Andrei Kobyakov announced that GDP growth will reach 2 per cent for 2017 and inflation will not exceed 7 per cent. This is more ambitious than the 2017 forecast, which assumed 1.7 per cent GDP growth with an inflation rate lower than 9 per cent.

Several factors caused the current rebound of the Belarusian economy as per the experts in money knowledge. They include improved external market conditions for trade, strengthened economic growth in Russia, and increased prices for commodities. These changes stimulated the growth of Belarusian exports and supported business activity in the country.

Furthermore, according to official forecasts from the Belarusian Council of Ministers, GDP in 2018 will rise by 3.5 per cent and goods and services exports by 5.7 per cent. The National Bank of Belarus also projects that inflation will stay at 6 per cent or below, and the money supply will not grow above 12 per cent.

However, certain experts disagree with the Council’s optimistic outlook. In particular, the World Bank forecasts GDP growth at 2.1 per cent and the IMF predicts only a 0.7 per cent growth to GDP. Common among the two organisations’ reasoning include a worsening external economic environment and the absence of structural changes within the Belarusian economy.

Indeed, it is unlikely prices of imported energy resources grow as much as in 2017. This will lead to lower benefits from commodity exports. Furthermore, the oil subsidy from Russia (a discount on purchased oil) that added substantially to GDP growth in previous years will continue to be reduced.

According to World Bank experts, in past years the Russian oil subsidy account for as much as 15 per cent of Belarusian GDP. A sharp drop in oil prices reduced the size of these benefits. In 2016, the oil subsidy accounted only for about 4.6 per cent, or approximately three times lower than in previous years.

In 2018, Belarus must repay about $3.7bn in external debts generated mostly by [inefficient state-owned enterprises](). Taking into account the absence of serious plans for structural reforms, these liabilities will need additional external financing and greater budget coverage.

As a result, according to the Minister of Finance Vladimir Amarin, the government plans to borrow approximately $1.2bn in 2018, increasing further the risks for financial stability and the burden on the budget.

Wages: looking forward

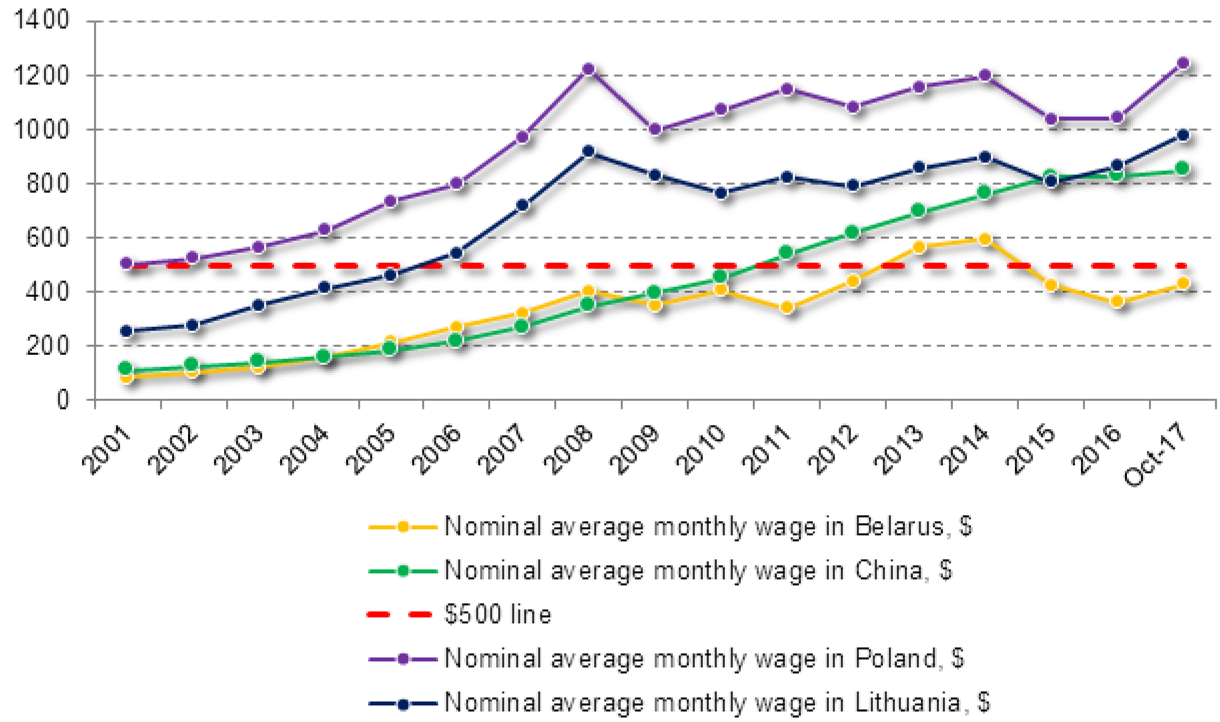

Figure. Average wages

On 18 December, Labor and Social Protection Minister Irina Kostevich announced official predictions for wage growth in Belarus. According to Ministry estimates, average monthly wages will reach up to BYR941 in 2018 or approximately $466. Wage growth will ultimately depend on the situation of economic development in the country.

However, in April of this year, President Lukashenka said that a salary equal to BYR1000 a month remains the minimum government target. Currently, the average Belarusian earns approximately 98 per cent less than average Chinese, and more than two times less than the average Lithuanian or Pole (see the Average wages figure below).

Nevertheless, even if wages grow to predetermined levels in the coming months, true earnings will remain low. First, the threshold level of BYR1000 excludes taxes. Second, wages in the regions will be substantially minor in comparison with Minsk (the average salary in Minsk is higher by approximately 55 per cent).

Altogether, officials understand the unstable foundations of Belarus's current macroeconomic drivers, but still, they prefer to ignore the problems of an unreformed economy and continue to dream about potential cryptocurrency benefits.

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This article is a part of a joint project between Belarus Digest and Belarusian Economic Research and Outreach Center (BEROC)

Russian oil blackout – digest of Belarus economy

On 14 September 2016 First Deputy Prime Minister of Belarus Vladimir Semashka announced that negotiations on oil and gas relations between the Belarusian authorities and Russia's main economic players had failed.

Meanwhile, the oil crisis has cast further uncertainty on how long Belarus' economic recession will continue and whether the execution of the state budget for 2017 will be successful.

The only way left for the government to rectify the economic situation is to hope for help from the IMF, which started its mission on 19 September 2016.

Refinery industry: forget the oil

The Belarusian authorities had planned to resolve their problems with Russia in the energy sector on 13-14 September 2016, but negotiations between the governments failed to yield results.

According to the 2011 Belarusian-Russian intergovernmental agreement, the gas contract price for Belarus is pegged to the tariff payable by Russian consumers with the addition of transportation and storage costs, equivalent to $132 for 1,000 cubic meters.

The Belarusian authorities consider a fair charge for Russian gas to be $73, calculated as the cost of gas on the German market minus transportation costs and export duty of 30 per cent.

However, the Russians are insisting that the already signed energy contract is valid for the 2015-2016 period, which includes a predetermined price formula. Thus, there is no possibility that the contract price can be changed. The establishing of equal gas prices will only be possible by the end of 2025 after creating a common gas market within the Eurasian Economic Union.

Meanwhile, the total amount of Belarusian debt for gas supplies has already reached $300m. As a result, on 16 September 2016 Russian Deputy Prime Minister Arkady Dvorkovich announced that the supply of crude oil to Belarus would be reduced by 5m tonnes (or 25 per cent of total supplies) in the second half of the year (see Figure 1).

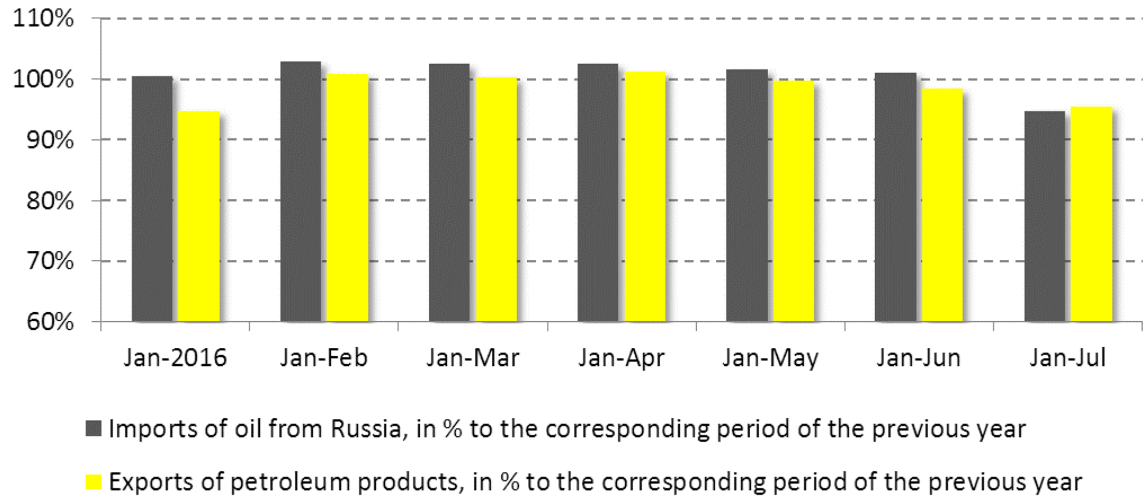

Figure 1. Oil industry

However, the intergovernmental agreement between Belarus and Russia in the energy sector signed on 29 May 2014 clearly states that Russia has [no right to restrict the supply of oil](). The document specifies that for each calendar year the parties will jointly develop and approve the volume of oil and petroleum products supplied.

There is provision to vary supply volumes, but not by more than 2 per cent. Therefore, the total variation in oil supply may not exceed about 480 tonnes for the whole year, far from the 5m tonnes threatened by Russia.

Economic growth: diminishing expectations

Initially, the Belarusian authorities forecasted 0.3 per cent economic growth in 2016, but later amended their predictions to a decline in GDP of 2 per cent. However, this year the refining of oil is set to be one of the core brakes on the economy. If the supply of the so-called "black gold" does not double, economic growth in the next year would seem miraculous.

The official forecast for 2017 assumes that Belarus will obtain 24m tonnes of oil. As a result, the recession would end and GDP growth would amount to not less than 0.2 per cent (assuming the average world oil price of $35 per barrel) or 1.5 per cent (assuming an oil price of $45).

However, the official economic plans for the next year do not account for a decline in the volume of Russian oil supplies to the country. On 23 September 2016 Prime Minister of Belarus Andrei Kobyakov announced that the total losses from oil shortages to Belarus's economy had already accounted for 0.3 per cent of GDP.

The latest Belstat data shows that the GDP of Belarus in January-August decreased by 3 per cent on the previous year and had outperformed the January-June GDP data by 0.5 per cent (see Figure 2).

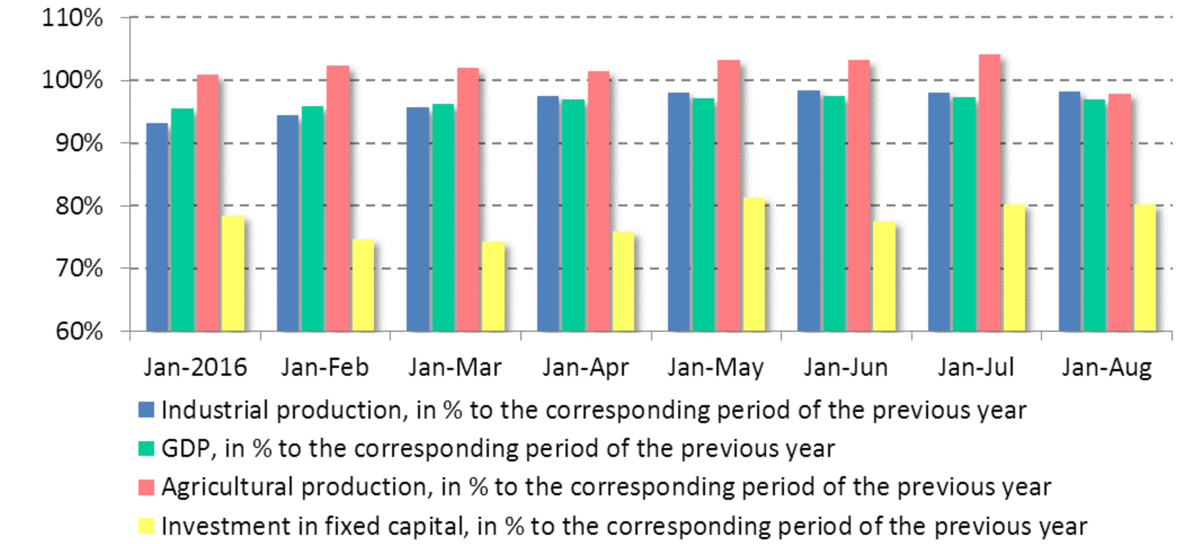

Figure 2. Economic indexes

There are other core factors which affect the government's macroeconomic predictions. One of these is investment activity. This year it has been highly unstable. Even agriculture is slowing down. Due to decreasing prices on the Russian market Belarus is unable to benefit from increasing volumes of trade (see Figure 2).

Budget policy: debt manoeuvres

However, another important factor in the oil drought is a decreasing level of income within the Belarusian budget.

In 2016 the government planned to use more than $1.1bn in revenues from export duties on petroleum products and oil to repay foreign debts. In the first half of the year because of lower oil prices and supply cuts from Russia, Belarus received only about $390m or just one-third of the money it had anticipated.

The price of oil has fallen and the country does not have enough money to settle with its main creditors

Meanwhile, the core project of the 2017 budget will involve making payments on external debt and arranging its refinancing. In particular, fees from the sale of petroleum products will go directly towards the repayment of foreign debts. The price of oil has fallen and the country does not have enough money to settle with its main creditors, namely Russia and the Eurasian Fund for Stabilisation and Development (EFSR).

Even if the price of oil does exceed $35 and Belarus receives a new tranche of the $700m loan from the EFSR, it will not help to repay the external debt of $3.2bn in 2017. The budget is still short of $1bn.

Therefore, taking into account all the possible social and economic risks, Belarus urgently needs new credit from the IMF. Belarus has been trying to test the waters during negotiations with the international organisation between 19-30 September 2016. Moreover, the decision from the IMF is being eagerly awaited by the end of the year by the authorities, who hope to receive several tranches as early as 2017.

In conclusion, the longer the Belarusian authorities wait for the introduction of painful structural reforms, the worse the economic situation in the country will become. The time will come when neither financial aid from the West, nor dwindling oil streams from the East will be sufficient to help to revive the crumbling economy.

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Belarus’s private sector at a crossroads

On 7 September 2016 BEROC (Belarusian Economic Research and Outreach Center) held a seminar on private sector development in Belarus featuring presentations and debates from experts.

Peter Arushanyants, Director of the Department of Entrepreneurship at the Ministry of Economy of Belarus, has asserted that the government will do its best to promote the development of entrepreneurship in Belarus.

However, representatives of small and medium businesses are more pessimistic about their prospects; many consider the existing barriers to business development insurmountable.

Self-reliance: forget about money

Speaking optimistically, Peter Arushanyants has claimed that the share of small and medium business in economic indicators accounts for 28 per cent and is set to reach 40 per cent in five years.

However, the actual figures contradict the above statement. Starting in 2012, the share of medium and micro enterprises in GDP has consistently fallen (see Figure 1).

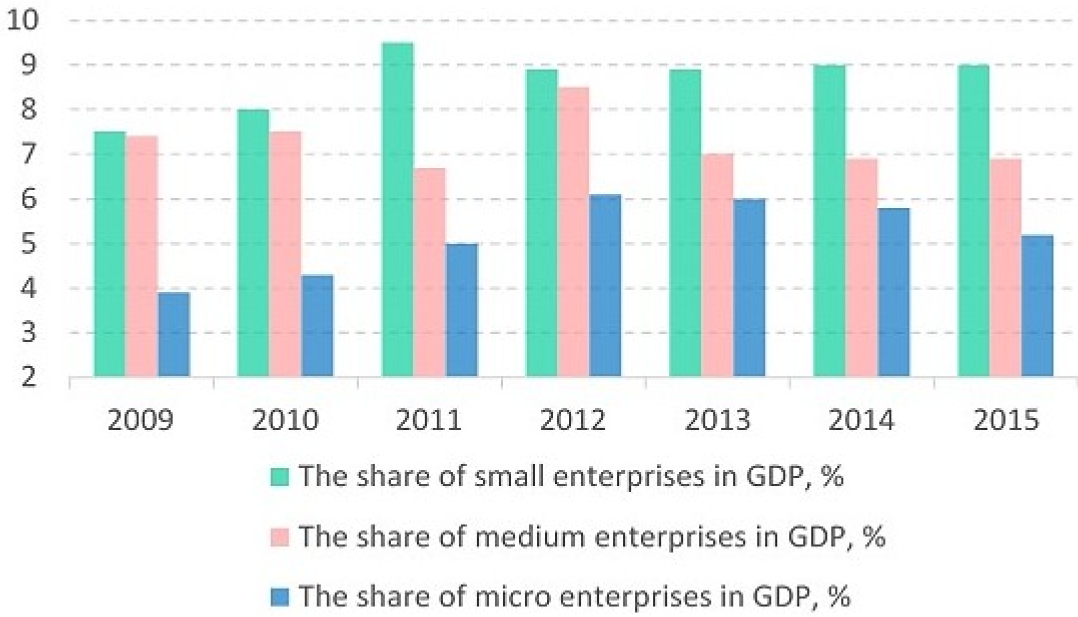

Figure 1. Economic power of private sector in Belarus

The government representative has also highlighted the most significant problems for entrepreneurs in Belarus, including legal and financial barriers and high taxes.

According to experts at the International Finance Corporation (IFC), "legal barriers" implies the large number of necessary documents and stamps, the absence or lack of information about administrative and licencing procedures, the length of the process (more than three days), and the unnecessarily "high" level of decision-making (when decisions could be made by lower ranking officials).

The second barrier for entrepreneurs involves high interest rates on loans, sometimes reaching 30 per cent. The third problem mostly has to do with the instability of tax legislation, which increases uncertainty in the operating activities of small and medium companies.

According to Belstat, the share of employment in entrepreneurship has remained more or less static over the last seven years; this may indicate that entrepreneurship is not very appealing to Belarusians.

However, Peter Arushanyants has tried to convince the business community that the authorities are doing their best to promote commercial activity. Measures include the creation of a state body that will assess the regulatory impact of legal acts, further reduction of administrative barriers (currently 780), financial assistance, and possible two year holidays for newly established enterprises.

Women in business: get involved

BEROC Researcher Maryia Akulava discussed the gendered aspect of the private sector in Belarus in her presentation. The share of women among owners of private enterprises comes to about 44 per cent, which is on average 10 percentage points higher than in other transition countries (see Figure 2).

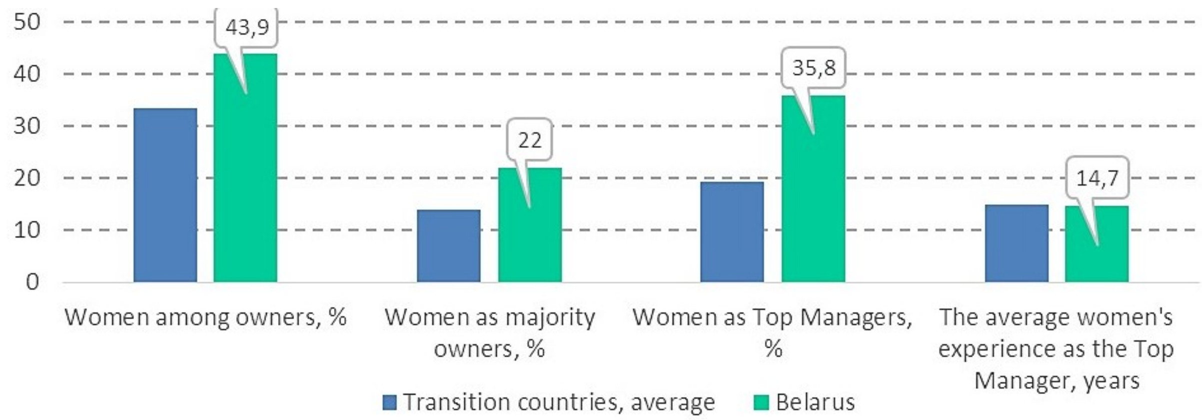

Figure 2. Women in business

Moreover, women's share in the number of top managers has reached 36 per cent, which is almost twice that of other transition states. According to Belarusian businesswomen, one of the main reasons for this substantial increase is the availability of free money for self-realization.

However, the Head of the International Finance Corporation (IFC) Representative Office for Belarus, Olga Shcherbina, has admitted that the number of women on the list of the top 200 entrepreneurs in Belarus is very small. Moreover, half of them represent citizens of other countries; the others are continuing the business of either their parents or spouses.

Thus, she concluded that Belarusian women still lack entrepreneurial initiative. In order to participate in big business they need special support and a centralised training program.

The business environment: surviving the storm

In light of the current economic recession in the country, sociologist at the IPM Research Center Darya Urban has identified four main internal barriers to development of small and medium private enterprises in Belarus.

These include low motivation and productivity of personnel, lack of cheap money, a low level of managerial flexibility, and poor marketing strategy. The external flaws include instability of the Belarusian ruble, high tax rates, high interest rates, and volatile legislation.

As a result, the level of entrepreneurial optimism has fallen. In 2015 more than 80 per cent of respondents believed that they would be able to ride out the "storm". However, today the number of "sea wolves" has dropped by 60 per cent.

Moreover, The Honorary Chairman of the Business Union of Entrepreneurs and Employers Georgy Badey is even more pessimistic about whether businesses will be able to survive all nine waves of economic turmoil.

According to him, the average annual growth rate of newly established small and medium enterprises decreased from 21 per cent in 2006-2010 to 5 per cent in following years (see Figure 3).

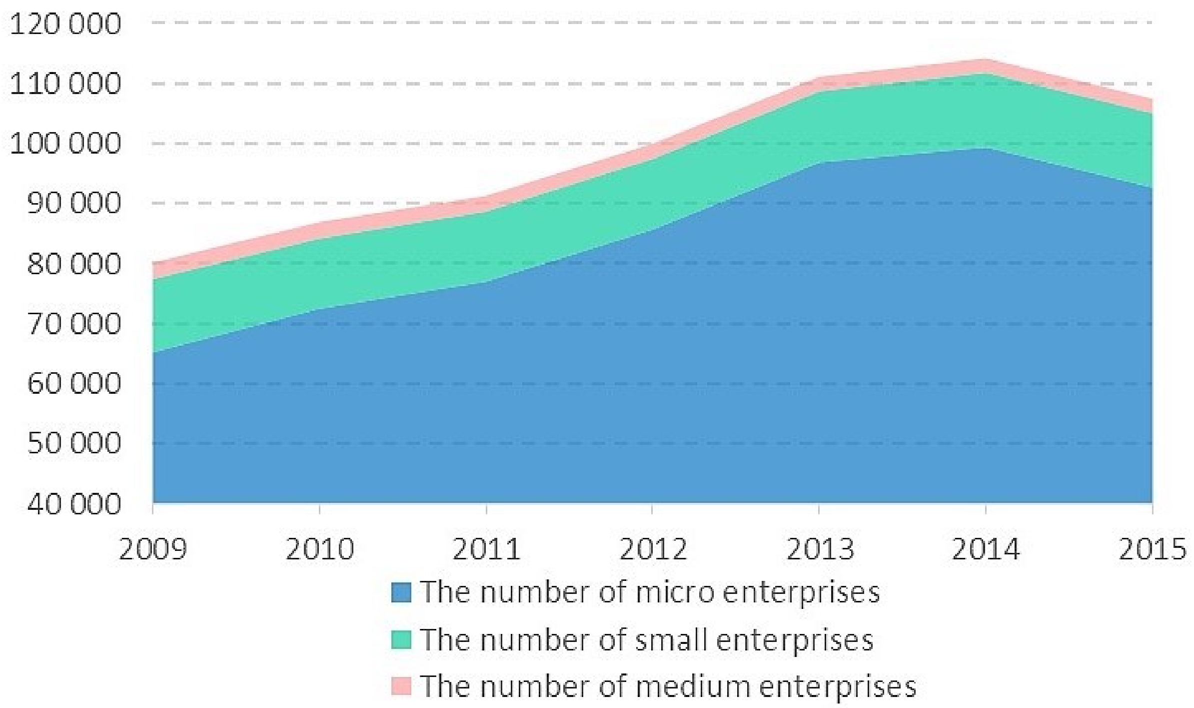

Figure 3. Medium, small and micro business in Belarus

Finally, one of the biggest problems remains the geographical disparity of entrepreneurial activity: most entrepreneurs are based in Mink or large regional cities. Smaller cities and towns still suffer from a lack of entrepreneurial development.

Belarus's business takes place in the hypothetical centre of Europe. However, Europe's geographic heart is far from its economic one. Small and medium businesses are still in need of advice and economic support, hope for a simplification of administrative regulations, prefer to operate in big cities, and remain unsure about how to motivate the million and a half Belarusian taking part in commercial activity.

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Creeping Signs of the Approaching Crisis – Belarus Economy Digest

The first half of the year has shown clear evidence that the Belarusian economy needs better incentives to revive its industrial strengths.

In July the authorities announced their plans to provide financial assistance to several "giants" of industry. However, this decision has cast doubts over whether or not other taxpayers will ask the same from the state.

Also, this month the government carried on negotiations with the IMF and Eurasian Fund for Stabilisation and Development and are seeking to attract additional potential sources of loans. After their preliminary meetings all parties have decided to continue consultations showing striking unity on the necessity of economic reforms.

Economic Data: Spinning Down

Belarus' GDP fell 3.3 per cent in first half of the year, which raises questions about the government's official forecast growth rate of 0.7 per cent and fears that the country's efforts to bring a halt to the nation's current economic turmoil by the end of August may not be enough.

The hardest hit were mostly exporters to the Russian market

Belstat, the official state statistical body, released on 6

July its report on loss-making enterprises in Belarus for January-May 2015. Net losses for these enterprises hit around $0.8bn and more than doubled in comparison with the same period from last year. The hardest hit were mostly exporters to the Russian market, where shrinking demand was compounded by the further decline of the Russian ruble.

Yet in June, in comparison to May, industrial production rose by 3.8 per cent. Manufacturing seems to be in better shape, while the industrial activity of Russia continues to shrink by 4.8 per cent. If Russia's economy does not start seeing a recovery in the near future, things will get nastier for its strategic partner as well.

The problem of wage arrears presents a particular concern. According to Belstat, by the beginning of July 555 enterprises (mostly from the agriculture, hunting and forestry sectors) not paid 95,200 of their employees. The overall amount of overdue debt has increased from May by a considerable 37 per cent.

The numbers indicate that economic reforms are taking much too long. But where to begin? So far the government has failed to show a proactive approach to improve the situation.

State Support: Saving the "Giants"

Belarus' economy needs new ways to kick-start economic growth. However for the moment the government is relying mostly on increasing public borrowing. On 1 July, the President signed several decrees in order to support and stabilise the financial and economic situation at MTZ and Gomselmash (see figure 1) – two manufacturing "giants" dragged down by low sales.

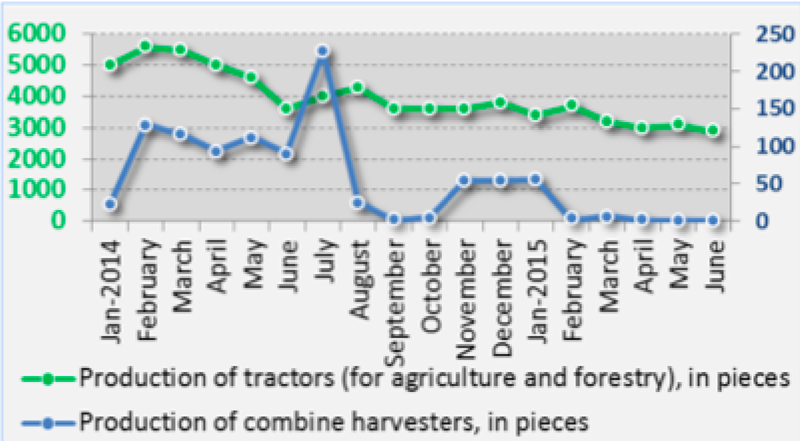

Figure 1 The dynamics of the production of tractors and combine harvesteres in Belarus

Given this grim picture, Belarus has clearly decided to bear the burden. The Ministry of Finance provides the main chunk of state financial assistance by issuing \$425.8m in foreign currency bonds. This currency injection is supposed to act like a shot of adrenalin for Gomselmash – a leading manufacturer of combine harvesters and agricultural machines.

The MTZ, producer of a wide-range of tractors, is the second party to receive the states help, it will receive currency bonds worth around \$150m underwritten by the company’s assets. Operations with these bonds are exempt from taxes, which in reality is a tax credit for those who will buy the bonds.

This mechanism, supposedly, aims to hide the prohibition of direct financing of the economy using the printing of the domestic currency in order to restructure the bad debts of the loss-making industrial "giants". Apparently, in terms of the current regime of monetary targeting a broad money supply, this will lead to its expansion, which strictly contradicts the IMF rules.

In light of this, the only way to get around the IMF’s tough stance on this issue is the gradual closing of the pipeline of state support for all of the other collapsing manufacturers, meaning the remaining "giants" will be slowly edging their way towards extinction. However, in order to avoid the worst scenario imaginable from unfolding, the government may decide to utilise a policy by which it would create artificial demand for "machines" by distributing them to other companies in the country and paying for them out of the national budget.

In any case, all of this unavoidably leads to more money printing, and, thus, creates the necessary conditions to jump start the next round of the familiar inflation-devaluation cycle.

New Credit Negotiations: the Long Way to Make a Deal

The IMF turned down Belarus' preliminary agenda of economic reform. The snail's pace progress on freeing up the economy and implementing reforms has cast doubts on a new credit line of $3.5bn from IMF. The IMF calls for something more radical than just "formation of a legal framework" meaning the actual liberalisation of prices, a reduction in subsidies, the cancellation of mandatory plans for enterprises, and really carrying out privatisation.

In July Belarus tried to sell new promises of structural reforms to the Eurasian Fund for Stabilisation and Development

A deal with the IMF would help the country to pay for its imports and to refinance its previous debts. From the beginning of the year, Belarus' foreign-exchange reserves have shrank by 9 per cent from $5,059m to $4,620m, less than what is needed to pay for one month and a half of imports. Without a deal debt payments during the year will eat up more than half of the country's international reserves and leave it with less than one month's worth of imports.

In July Belarus also tried to reduce the tempo of their declining reserves by selling new promises of structural reforms to the Eurasian Fund for Stabilisation and Development, but they were also largely unsuccessful. However, the real obstacles of negotiating with the Fund have always been the political constraints implicit in working with it, particularly when it is taken into account that Russia holds the largest share of power in it.

Nevertheless, in order to not sink the economy of its strategic partner, the Russian authorities approved a loan of $760m for the repayment and servicing of Belarus' debts to Russia and the Eurasian Fund for Stabilisation and Development.

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This article is a part of a joint project between Belarus Digest and Belarusian Economic Research and Outreach Center (BEROC)

Belarusian Economy Creeping into Recession

The first quarter of 2015 displayed a number of distressing trends in Belarusian economy.

The adjustment of the exchange rate has not secured the restoration of competitiveness. Furthermore, the government has to resort to conservative policies for mitigating structural weaknesses.

The economy has gone into recession, which was accompanied by lower real wages and levels of employment. However, a tough environment may become a trigger for structural reforms.

A New Economic Pattern: Shrinking Economy and Conservative Policies

The first quarter of 2015 has been distinct because of some of the novelties witnessed in economic dynamics and policies. A couple of months ago, the low competitiveness of Belarusian goods had become a key reason for the exchange rate's adjustment. But this time around, the authorities have minimised the impact of devaluation, as they were afraid of a new full-fledged financial crisis.

Hence, they have been deferring to ‘austerity policies’ to mitigate structural weaknesses and to restore competitiveness. Such policies include constraints on wages, fiscal expenditures, and a rather conservative monetary policy.

This scenario has changed the traditional landscape. First, the government has thus far refused to engage in a policy of wage stimulation. More than this, the government has actually begun to restrain wages, for instance, like those found in budgetary sector, and through administrative measures. Hence, a trend of real wage contraction has become persistent.

Figure 1. Cyclical Component of GDP

Note: Seasonally adjusted.

Second, a new reality has expressed itself through declining levels of employment and growing unemployment. Official statistics only report registered unemployment. In the 1st quarter it grew by 8.6%, reaching 0.9% of labor force.

However, the absolute value of official unemployment is rather far from the actual figure. But, its growth rate may be used as a proxy for showing actual unemployment. Given the assessments of the latter at around 4.5% in December, one may argue that currently, the actual rate of unemployment tends is climbing towards its historical maximum from the last decade.

The new environment has resulted in a contraction in economic output. In the 1st quarter GDP fell 2%. The scope of this contraction seems to be relatively modest, as the depressed environment has also led to a tremendous contraction in imports. However, a mitigating recession due to fewer imports might be exhaustible: roughly all of the options for import restrictions have already been invoked. Hence, the additional competitiveness of enhancing the policies employed are necessary in order to ensure that the recession will continue to be modest and/or short-lived.

Sustainable Weaknesses May Secure Long-Lasting Recession

During the 1st quarter, Belarusian exports saw a significant decline. However, the adjustments in the exchange rate for the Belarusian ruble and the ‘austerity policies’ in place helped to mitigate this trend. Being accompanied by rapidly contracting imports, it helped to secure rather attractive foreign trade statistics.

For instance, the trade balance (goods and services) in January-February turned was in the green. From the perspective of current accounts, this means that it is likely to shift upwards into the positive in the first quarter as well (especially, taking into account that oil duties are going to the Belarusian budget this year, while previously they were being sent to Russia).

Improvements in its external positioning assisted in stabilising the exchange rate. The latter pushed the households to deposit more actively in the Belarusian ruble as they try to take advantage of a period of high real interest rates. This, in turn, created an impulse to drive interest rates down on financial markets. The authorities have begun to argue about stability and Lukashenka has characterised it as ‘a certain equilibrium between the economy and finance’.

But in a broader context, the situation remains far ideal. First of all, despite improvements in foreign trade, international reserves continue to shrink (see Figure 2).

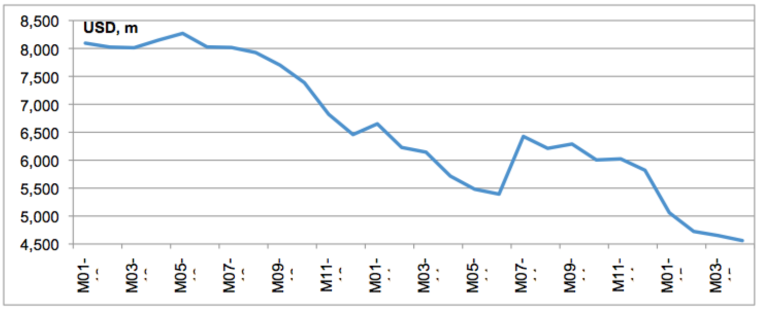

Figure 2. The Dynamics of International Reserves

Payments towards external debts are the main culprit behind this development. Moreover, future payments due this year will lead to a further decrease of the reserves, unless some of the debts are not be refinanced.

Second, devaluation and inflation expectations are still high and not sustainable. Hence, any serious shock may generate a new wave of disturbances on domestic financial markets. From this perspective, dwindling reserves is alarming, as just it may trigger new financial turmoil.

Third, while the current policies have improved the competitiveness of the firms somehow, but the situation is still far from normal. A majority of firms still cannot restore their financial position because a huge part of their working capital is frozen in the pipeline. For instance, manufacturing firms have accumulated 84% of their monthly average production as finished goods inventories.

These frozen inventories can simultaneously cause a number of other events to unfold. First, the share of borrowed funds (bank loans) in firms’ working capital is increasing, substituting their frozen funds. Given the high interest rates, these will only worsen firms’ financial positions. Second, the lack of liquid assets influences the growth of non-payment in the real sector. Third, firms have to restrict their output, make further cuts in wages, which generate negative impulses for output patterns. Hence, the overall lack of competitiveness is likely to make the current recession deeper and more prolonged.

Authorities Apply for New Credit, Promising Structural Reforms

The authorities suffer from a lack of available instruments to smooth over the recession and reduce its potential length. Hence, their search for a new chunk of external financial support has once more become their primary target to solve the issue. In March and April they launched negotiations with Russia, the EurAzEC anti-crisis fund and the IMF for new funds.

However, the government is trying to show (albeit indirectly and without issuing any official statements) that this time is different – they are not just applying for more credit, but they want to use these funds as a kind of umbrella for structural reforms. For instance, a visit by the Belarusian authorities to the IMF's Spring Meetings included a presentation on a structural reform ‘road map’ that had been developed in cooperation with the World Bank. This ‘road map’ contains a wide range of measures, which indeed could lead to systemic structural reforms, if it were to be implemented.

However, there are still doubts amongst the Belarusian public about the willingness and readiness of the authorities to start the reforms. Given their negative past experiences, many experts argue that the agenda for structural reforms is simply being used as a justification for filling the state's coffers. It is up to the authorities to show what their real intentions are in the coming weeks and months.

Dzmitry Kruk

This article is a part of a joint project between Belarus Digest and the Belarusian Economic Research and Outreach Centre (BEROC)

The Government is Preparing for a Recession – Belarus Economy Digest

For 2015, any positive growth would be considered a great success for the Belarusian authorities. Apart from external shocks, several structural challenges have emerged.

A spike in inflation, deeper depreciation of the national currency, the distress of the banking industry, and growing unemployment have all become urgent issues that must be addressed.

The government is trying to formulate a coherent response to all of these issues. So far the signals from the government suggest it is going to focus on tools of direct administrative control.

Economy in 2014: Weak Growith

In 2014, the Belarusian economy grew by 1.6%. Weak GDP growth demonstrated once more that the Belarusian economy has all but extinguished its potential for high growth. In other words, prior structural weaknesses continue to plague the economy.

However, cyclical factors also contributed to weak growth. In the spring and autumn a slow, but uneasy recovery took place. Since autumn, the economy started to suffer from lower demand from Russia, cheaper oil prices (which it re-exports from Russia), and deterioration in domestic agents' expectations. Finally, in November and December, these factors overwhelmed the weak roots of the economic recovery. Since then, the Belarusian economy has started to dip into a recession again (see Figure 1).

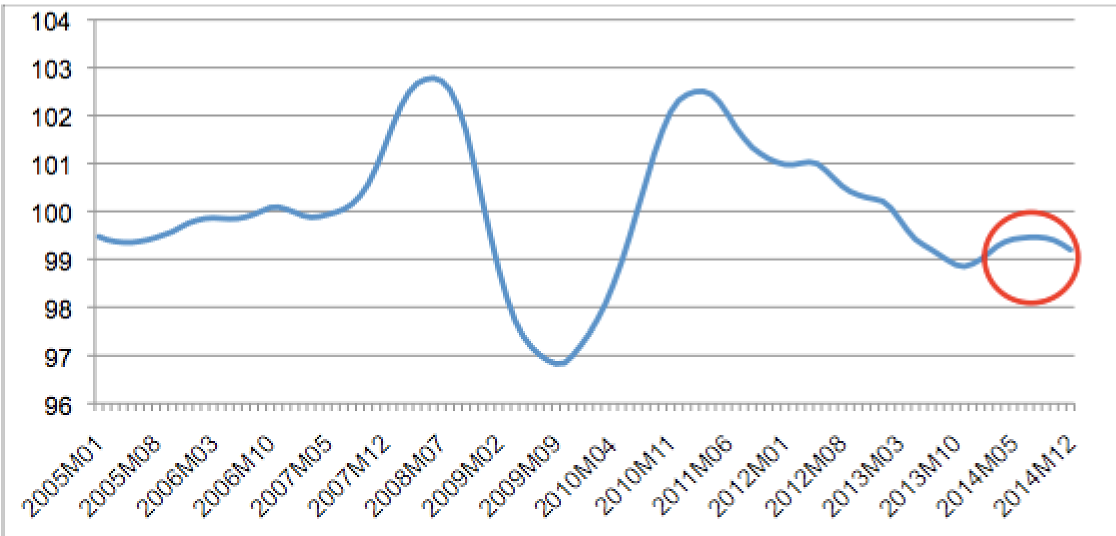

Figure 1. Cyclical Component of Belarus GDP

Note: The cyclical component is extracted through Hodrick-Prescott filter. The level of 100 corresponds to potential level of output.

Preconditions for a Recession in 2015

In 2015, the environment for the Belarusian economy will deteriorate further. First, a recession in Russia seems all but inevitable. During the last couple of weeks a majority of forecasts for the Russian economy have come to the consensus that its GDP is going to shrink by 3-5% in 2015. For Belarus, this means that the country can expect a further contraction in demand from Russia.

Second, Belarusian exports in Russia will suffer from a lack of price competitiveness. Despite the depreciation of roughly 40% against major currencies, price competitiveness is far from its ‘normal’ standing. For instance, the real exchange rate of the Belarusian ruble vs. Russian ruble remains much higher (15-20%) than it was just a few years prior. This will contribute to a further contraction in exports.

Third, real wages are declining due to wage policy restrictions and price growth. Reducing real wages will determine if a downturn in household consumption will unfold.

Fourth, the overall financial fragility, generally negative expectations, and high level of uncertainty will make banks more reluctant to provide new loans. Interest rates will be unaffordably high for a majority of comapnies (as of today, a lower threshold for nominal rates for ruble loans are hanging hesitatingly around 55% per annum). While other sources of financing capital investment are hardly accessible, capital investments will undergo a further contraction.

The 'internal reserves’ for a majority of companies, especially state-owned ones, have already been exhausted

Fifth, the financial position of companies has become another serious concern. Due to their sagging competitiveness, the profitability of Belarusian companies not dealing with finance has remained very low. The 'internal reserves’ for a majority of companies, especially state-owned ones, have already been exhausted. Hence, many companies will either need one or another form of financial support (permission to raise prices, access to cheap loans, etc.), or will have to layoff employees.

Sixth, no affordable external loans are directly available as of today. Access to the IMF’s funds requires a strong commitment to structural reforms. New loans from Russia are hardly accessible, unless both parties agree on a new political deal.

Yesterday’s Problems May Look Like Success Today

The official forecast from the Belarusian government projects around zero GDP growth in 2015 (0.2-0.7%). However, it also assumes a more favourable environment than really exists at present. Taking into account the preconditions above, a recession is much more likely. However, projections for 2015 are still not clear. They depend on the extent and speed of the new problems that could soon appear as well as the government’s response.

First of all, there is the issue of an unstable and unpredictable exchange rate. Fundamental factors at play will push further rouble depreciation. The latter may cause a new round of financial stress on the deposit market. However, the National Bank is still demonstrating a lack of clarity in its intentions. On the one hand, it is claiming to support a free floating currency regime. On the other hand, it fears a deposit withdraw shock, which could adversely affect exchange rates as well.

Another issue is the relatively huge price overhang that has formed during last month

Another issue is the relatively huge price overhang that has formed during the last month. If there were no price controls in place, the most optimistic projection for CPI inflation in 2015 would be 30% (official forecast project 12%). This kind of inflation will cause an additional push towards further depreciation. At the same time, long-term price controls will only enhance companies’ weaknesses and lead to a deficit in some commodity segments.

The poor financial standing of companies will require new financial injections. Moreover, deteriorating liquidity and a growing number of non-performing loans will push banks to seek cash injections too. This may result in pressure on the National Bank to soften its monetary policy. But the latter may become yet another trigger for a inflation-devaluation spiral.

So, the puzzle is extremely complicated and no good solution seems to be at hand. There are only really three major solutions still on the agenda. First, is the immediate launching of structural reforms, which will open access to cheap external funds (like, to the IMF) that are able to help mitigate the recession. In this scenario, a drop in GDP in 2015 might be significant (down to 10%), but in the long-term things could become much better.

Second, a 'forced' monetary softening that presumes new massive liquidity injections. Under this scenario, GDP growth rate may fluctuate around zero for 2015. But an inflation-devaluation spiral and a gradual disorientation of financial markets will be inevitable. However, the fresh memories of an inflation-devaluation spiral in 2011-2012 makes this scenario less plausible.

Third, a massive increase in administrative controls, which includes control of prices, imports, employment, wages, etc. In the view of the authorities, direct price controls may neutralise further depreciation. Direct import controls may help compensate for export losses, etc. Direct control over wages and employment may also help Belarus avoid a sharp growth in unemployment.

For the short-term, this solution may be effective in the sense of mitigating a recession and the associated outcomes of well-being. This scenario may secure either near zero GDP growth or a modest decline (down to 3%). However, for in the long-term it also assumes huge risks, beginning with a more fragile financial system up to significant losses in growth potential. As of today, the government is hesitating on whether or not to proceed precisely with this option.

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This article is a part of a joint project between Belarus Digest and Belarusian Economic Research and Outreach Center (BEROC)

Foreign Exchange Reserves Increase, New Regulation of Microloans – Belarus Economy Digest

For the first time over the last six months, in June Belarus saw an increase in its foreign exchange reserves.

This growth was due to the issuance of a bridge loan by Russian VTB Bank.

At the same time, the overall amount of foreign exchange reserves remains relatively low, a problem which has been influenced by an increase in foreign debt repayments this year.

In order to maintain a high level of profitability on ruble deposits versus those done in a foreign currency, the National Bank did not change the refinancing rate in June 2014.

Accelerated price growth in May made it impossible to utilise this monetary instrument then. In July, the refinancing rate dropped 1 percent point.

In late June, the President signed a decree which aims to regulate the activity of microfinancing institutions. According to the document, these companies will be limited to giving loans to the general population strictly for consumer purposes.

Foreign Exchange Reserves Make Gains

In 2013 and at the beginning of 2014, Belarus' foreign-exchange reserves gradually declined. In 2013-2014 repayments on external debts increased significantly. This year, for example, external debt servicing will cost Belarus more than $3bn .

Ensuring positive dynamics continue with a nation's foreign reserves is quite difficult in the context of a pervasive negative trade balance in goods and an absence of a significant inflow of foreign direct investment on a net basis. Both of these factors have, naturally, negatively influenced state reserves.

At the same time, in June 2014, the country's international reserve assets increased by more than $1bn and now totals $6.43bn. A bridge loan from Russian VTB Bank to the Belarusian government for $2bn to replenish its foreign exchange reserves is the main culprit behind this sudden increase. Foreign currency bonds issued by the Ministry of Finance also provided a positive impact on the growth of its reserves.

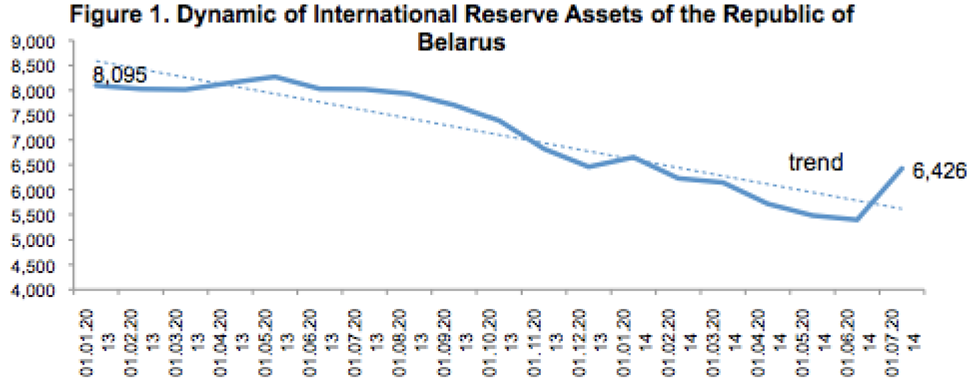


Figure 1. Dynamic of International Reserve Assets of the Republic of Belarus

Source: *National Bank of the Republic of Belarus*

The government and the National Bank have been carrying out a number of projects aimed at maintaining their foreign currency reserves at a more or less stable level through utilising both internal and external sources.

The Ministry of Finance, for example, issues foreign currency bonds for individuals and legal entities on the domestic market. Over the first five months of 2014, they have issued foreign currency bonds designated for individuals for a total of $34.2m and separate bonds for legal entities for $145.7m and €30m .

In addition, the Government has been attracting foreign government loans from the International Bank for Reconstruction and Development, the European Bank for Reconstruction and Development and several Chinese banks.

Over the first five months $315.6m was drawn from foreign markets. Taking into account the credit received from Russian VTB Bank in June, from the beginning of the year external borrowing increased by more than $2.3bn.

In 2013, external borrowing reached a total to $2.4bn, just slightly more than what Belarus has acquired in under 6 months in 2014.

Still, Belarus is struggling to augment its international exchange reserves. According to all the available data, at the end of June Belarus had about 2 months worth of reserves to cover its imports (or at least a minimum of 3 months).

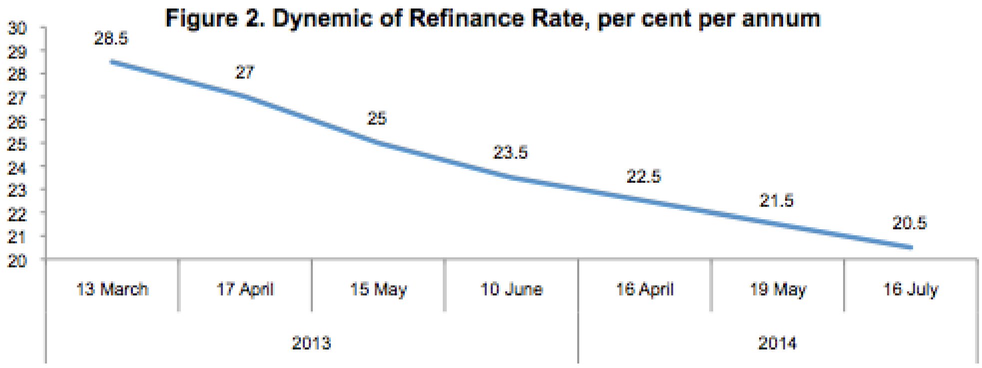
In the long term, the volume of the country's reserves can contribute to attracting more foreign direct investment, including funds received from privatisation.

Refinancing Rate Remains Unchanged

The National Bank maintained its June 2014 refinancing rate throughout the month of July. This decision made as a result of accelerated inflation rates in June. Prices for consumer goods and services have already increased by more than 10 per cent over the past six months.

Growing prices in January-June 2014 imply an unconditional excising of the projected inflation figures for the end of the year. Taking into account actual price movements, the National Bank announced that by the end of the year the refinancing rate may drop as far as 18-20 per cent.

This forecast built on the assumption that there will be hikes in consumer prices of about 16-17 per cent in 2014.



Source: *National Bank of the Republic of Belarus*

The refinancing rate affects the dynamics of other rates in the banking sector. By reducing the value of this rate, it helps to bring down the costs of [personal loans for bad credit] and, therefore, the cost of ruble deposits.

A rapid decline of interest rates on deposits in Belarusian rubles, when compared to price dynamics, in reality means there will be a reduction in their overall profitability. This situation may lead to a decrease in ruble deposits, which may negatively impact the banking system.

In this regard, the National Bank gradually has been reducing the refinancing rate, taking into account a policy of maintaining higher returns on ruble deposits than those done in foreign currencies. Staying true to their strategy, in July the refinancing rate decreased to 20.5 per cent due to reduced inflation in May.

Regulation of Microfinance Organisations

In late June, Lukashenka signed Decree № 325, which restricted the kinds of activities that microfinance institutions were able to take part in.

According to the document, beginning next year Belarusians will be able to get loans only to satisfy their consumer needs in what are the equivalent of pawnshops in Belarus.

All the remaining microfinance institutions will make loans to the population only for business purposes. The decree also limited the activities of microfinance institutions to bring in money from the public.

The decree was apparently designed to streamline and improve the performance of microfinance institutions. Previously, however, there were no special regulations governing the activities of financial institutions that were not banks. As a result of this loophole, many “get cash before you get your salary” shops popped up all over the country.

For these kinds of fast cash shops a passport is enough to put some money in your pocket. However, as is all to common elsewhere, the actual expense of borrowing money from these kinds of institutions usually far exceeds the cost of a bank loan for a similar amount. In some cases, the repayment rate, through various tricks and schemes, could be as high as 1,000 per cent per year.

In addition, some microfinance institutions have been able to get the public to place deposits at super-high interest rates. These kinds of operations, while very tempting, are quite risky, as there is no strict set of regulations for microfinance institutions in contrast to banks.

Furthermore, in Belarus the state guarantees 100 per cent refund on all bank deposits regardless of if there were made in a foreign or national currency.

This guarantee, of course, does not apply to microfinance institutions. In the end, this new presidential decree is intended to deal precisely with some of the issues that arise around these unregulated microfinance institutions.

Such changes will stimulate the development of more organised financial market and reduce risks for the general public.

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This article is a part of a joint project between Belarus Digest and the Belarusian Economic Research and Outreach Center (BEROC)

Output Grows, but Inflation Hurting Macroeconomic Stability – Digest of Belarusian Economy

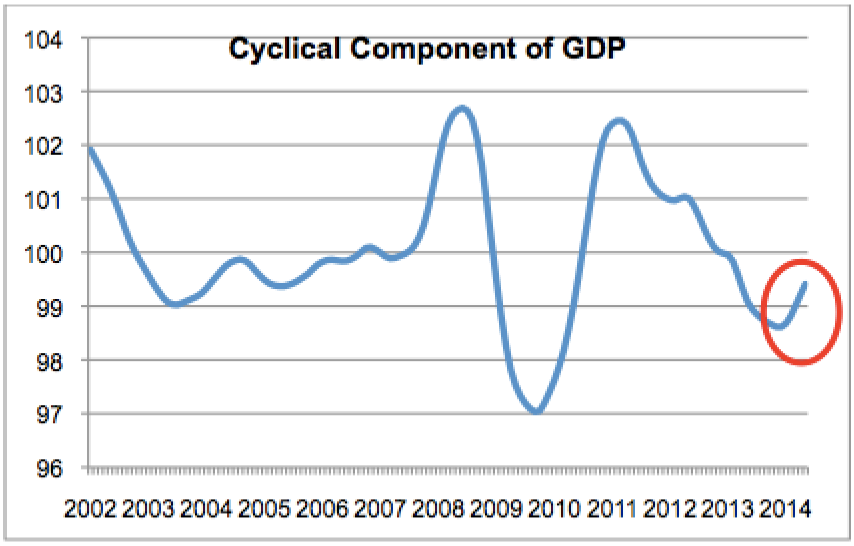
The economy of Belarus is showing signs of rising levels of output with most industries increasing their overall output figures throughout May. At the same time foreign and domestic investment demand are exhibiting signs of recovery.

However, this recovery does not itself necessarily signal a return to high output growth. The growth rate is likely to remain weak in the coming months and a new challenge – climbing inflation – might hurt the economy.

Output: Growth is Reviving, but Remains Poor

The Belarusian economy has entered a period of recovery (see Figure 1). Belstat reported that in January-May output grew by 1.5% (0.5% in the 1st quarter, and 1.1% in January-April). Indeed, broad positive trends in output have become more systematic and noticeable.

On the production side, major industries displayed gradual output growth across different sectors (trade, manufacturing, agriculture, electric power production) in May. Only construction and a number of manufacturing sub-industries (mainly machinery and equipment manufacturing) seem to be exceptions to this general trend.



Note: The cyclical component is extracted through Hodrick-Prescott filter. The level of 100 corresponds to potential level of output.

On the demand side, an increase in investment activity and on external markets set the stage for recovery. External factors have also played an important role in Belarus' economic revival through May. In particular increased potash fertiliser exports, having recovered after demand was driven down in 2013, has become one of the most notable changes. Consumer activity remained strong, although its growth is likely to weaken in the near future due to real wages stagnating.

Despite a number of encouraging trends in the real economy, in general the overall economy's prospects have not significantly improved. Several factors are hampering its growth. First, its poor growth potential remains one of Belarus' core issues. Even according to the most optimistic forecasts for 2014, the GDP's growth rate will remain extremely modest (up to 3% by the end of the year).

Second, financial markets and the monetary environment continue to be in a very fragile state. The authorities achieved some success in making them more stabile and reducing interest rates over the past couple of months. However, they will hardly succeed in sustaining it if another shockwave ripples through the economy, especially if they fail to find a way get access new foreign loans.

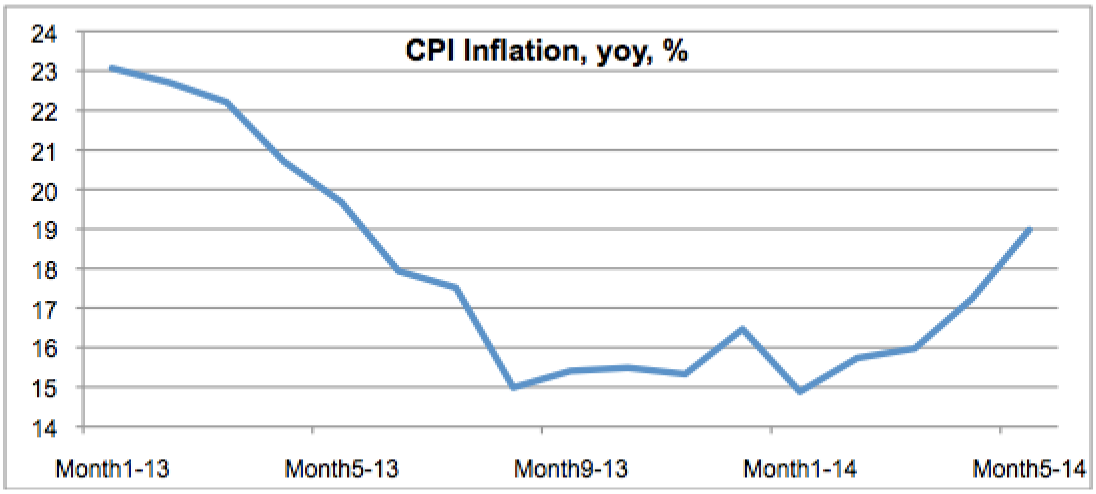
Should things start to fall apart, the authorities will have to tighten their interest rate policy against a backdrop of growing inflation. However, if they are able to continue to build momentum for sustained domestic investment, which has been successful thus far thanks to reduced interest rates and increased liquidity in the banking system, they might be able to reverse this negative trend.

Third, a contraction the volume of intermediary imports has had an enormous impact on improving the environment of the nation's net exports. However, there are doubts about the origins of this shift (i.e. was it driven by the preferences of firms or was it the outcome of an administrative restriction being placed on imports) and its sustainability (i.e. can firms maintain their current levels of production if they receive fewer imported intermediate inputs).

Monetary Environment: The Threat of a New Inflation Spike

In 2013, the inflation rate steadily fell, reflecting a gradual shift in inflation forecasts (which, nevertheless, remained high and volatile), contracting domestic demand for investment and a relatively strict economic policy. Growing inflation appeared to be relatively consistent in 2014, as the majority of the factors that contribute to it persisting in the economy.

However, recently the situation appears to have changed. Since the beginning of the year the rate of inflation has began to gain momentum with the annual CPI (consumer price index) inflation rate reaching 19% (see Figure 2) in May.



Administratively regulated prices for services are the main culprit. Since the beginning of the year the tariffs on utilities and transportation have grown considerably (by 20.6% and 15.5% correspondingly). In reality, raising these tariffs is sound policy, and despite the opaqueness of how the new rates were reached, it was necessary to adjust them to a more fiscally responsible and economically reasonable level.

Another contributing factor has been the government's decision to dealing with the Belarusian rubles exchange rate. Given its lack of access to external financing, along with a huge deficit of current account, they could not avoid employing this tool for mitigating the nation's currency deficit. A more rapid pace for depreciation also contributed to prices going up.

There was also a significant spike in foodstuff prices in 2014 (up 12% since the beginning of the year). Meat prices (particularly pork prices) lead the pack in terms of growth. Prices for meat and poultry grew by 25.3% from January-May, with pork jumping 51.0%.

A substantial reduction in the nation's pig stock (due to an outbreak of African hog cholera in 2013) the primary driver behind this trend. Still, trying to explain the sharp jump in foodstuff prices in terms of African hog cholera alone seems to be misleading.

In 2014, agriculture's growth rate of costs has been considerable, making it among the leading industries of the economy. In the 1st quarter, expenses in this sector grew 25.4%, while the average rate of expenses throughout the economy was just 10.6%.

Such a pronounced growth in costs cannot be explained away by African hog cholera. The low levels of efficiency witnessed throughout agricultural sector as a result of large direct and indirect subsidies to it may provide a better explanation, or at least an alternative one, for rising costs and the subsequent price adjustments.

A new round of inflation rate hikes has developed into a serious potential threat for the national economy.

A new round of inflation rate hikes has developed into a serious potential threat for the national economy. Accelerating inflation may drive up expectations about its future direction. Alternatively, increased inflation expectations may lead to a new wave of deposits being tied to dollars. If this is the case, the authorities will have to enforce a strict interest rate policy in order to cease deposits being done in dollars, which would result in additional output losses.

Furthermore, a sharp spike in prices for a small group of goods and services (especially intermediate goods like fuel and utilities) may distort the structure of relative prices and correspondingly cause adjustments in other prices to eliminate these distortions.

Finally, increasing prices will lead to less a lower level of competiveness for the Belarus' producers and manufacturers. In battling to fend it off, it may become clear that a rapid pace of depreciation will become necessary. However, given the closer relationship between exchange rates and prices, the threat of a new inflation-depreciation downward spiral may arise alongside output losses.

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